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No. 83-297

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

ARMCO INC.,

Appellant,

v.

DAVID C. HARDESTY, JR.,
State Tax Commissioner of West Virginia,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

APPELLANT'S BRIEF ON THE MERITS

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QUESTIONS PRESENTED

The following questions are presented by this appeal.

1. Whether the Due Process Clause and the Commerce Clause require a substantial nexus between a state levying a gross receipts tax on sales outside the state and the activity or transaction subjected to such tax.

2. Whether the "unitary business" principles applicable with respect to taxes on net income may be extended to state gross receipts taxes so as to permit a finding of sufficient nexus by reason of a taxpayer's activities in the taxing state which are unrelated to the taxed transaction.

3. Whether the Commerce Clause prohibits a state from imposing a non-apportioned gross receipts tax on wholesale sales of property manufactured outside the state, where an exemption from the tax is provided with respect to wholesale sales of property manufactured within the state.

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OPINIONS BELOW

The opinion of the Supreme Court of Appeals of West Virginia has not been officially reported, but it may be found at 303 S.E.2d 706 (W. Va. 1983). The opinion of the Circuit Court of Kanawha County, West Virginia, is not reported. Those opinions are reprinted in Appendices A and B, respectively, to Appellant's Jurisdictional Statement ("J.S.") at pages 1a and 25a.

JURISDICTION

On May 25, 1983, the Supreme Court of Appeals filed its opinion and entered its final order (Appendix D, J.S. 51a) reversing the judgment of the Circuit Court and remanding the action to the Circuit Court for disposition in accordance with such opinion.

On August 19, 1983, Appellant's Notice of Appeal (Appendix E, J.S. 53a) was filed in the Supreme Court of Appeals and in the Circuit Court, the court then possessed of the record. The time within which to docket this appeal expired on August 23, 1983, and timely docketing was made. This Court noted probable jurisdiction on December 12, 1983.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(2).

CONSTITUTIONAL AND STATUTORY PROVISIONS

United States Constitution, Article 1, Section 8, Clause 3 (the "Commerce Clause"):

> The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes . . . .

United States Constitution, Amendment XIV, Section 1 (the "Due Process Clause"):

> [N]or shall any State deprive any person of life, liberty, or property, without due process of law . . . .

West Virginia Code, Sections 11-13-1, 11-13-2, 11-13-2a, 11-13-2b and 11-13-2c, are reprinted in pertinent part in Appendix G to the Jurisdictional Statement at pages 57a *et seq*.

STATEMENT OF THE CASE

Business and Occupation Tax

The focus of this appeal is on Article 13 of Chapter 11 of the West Virginia Code of 1931, as amended, which imposes an annual business and occupation tax upon the exercise of the privilege of engaging in various types of businesses in West Virginia. *See* Appendix G, J.S. 57a-63a. To the extent relevant here, the amount of tax due is computed by the application of varying rates of tax to the gross receipts from sales of tangible property and to the value of products manufactured and coal mined within the state. For purposes of this proceeding, three applications of the business and occupation tax are of particular importance.

Wholesale Sales. The tax is imposed upon the gross receipts realized from wholesale sales of tangible property by persons engaging or continuing within the state in the business of selling tangible property. It is this application of the tax which is at issue in this proceeding. During the years involved here, the rate of tax was 0.25 percent and later 0.27 percent of the gross receipts from such sales. W. Va. Code § 11-13-2c.

Manufacturing. The tax is also imposed upon persons engaging or continuing in the business of manufacturing within the state. Manufacturers liable for this tax on manufacturing activities are exempt from the tax on wholesale sales of the manufactured goods. During the years 1970 through 1975 the rate of tax was 0.80 percent and later 0.88 percent of the value of the manufactured goods, defined to be gross proceeds from the sale of such goods. W. Va. Code §§ 11-13-2 and -2b.

Coal Mining. Finally, the tax is imposed upon persons engaging or continuing within the state in the business of mining coal. Armco acknowledged its liability for this tax and paid appropriate taxes for the years 1970 through 1975. The rate of tax varied from 1.35 percent to 3.85 percent of the

value of the coal mined during the years 1970 through 1975. W. Va. Code § 11-13-2a.

Facts

Armco is an Ohio corporation qualified to hold property and conduct business as a foreign corporation in West Virginia. This appeal centers upon the applicability of the West Virginia business and occupation tax to wholesale sales by Armco of three of its product lines to customers in West Virginia. The products involved are steel (manufactured by Armco's Steel Group division), wire rope (manufactured by Armco's Wire Rope Group division), and metal buildings (manufactured by Armco's Metal Products division). All of these contested sales had the following attributes in common:

(i) No salesmen resident in West Virginia were employed (Joint Appendix ("J.A.") 16, 19, 24);

(ii) No manufacturing facilities were maintained in West Virginia (J.A. 16, 27);

(iii) No sales or other offices were maintained in West Virginia (J.A. 16, 24);

(iv) No inventories of these products were maintained in West Virginia (J.A. 16, 27);

(v) All orders for these products were accepted or rejected outside West Virginia (J.A. 20, 27);

(vi) All of the products were shipped by common carrier from outside West Virginia, and title to the products was transferred to the purchaser outside West Virginia (J.A. 20, 21, 22, 27); and

(vii) Armco did not install, service or repair any of these products sold to customers in West Virginia (J.A. 21, 28).

With regard to the solicitation within West Virginia of orders for the sales at issue, all of the metal buildings were sold by

Armco to two franchised dealers, and there was no solicitation of orders for those sales in West Virginia.[1] J.A. 24, 28. Orders for sales of steel products were solicited in West Virginia by two nonresident salesmen from an Armco office in Pennsylvania and two nonresident salesmen from an Armco office in Ohio. These salesmen visited West Virginia on an average of every four to six weeks (with one of the salesmen from the Pennsylvania office visiting West Virginia twice a month). J.A. 19, 21. Orders for wire rope products sales were solicited in West Virginia by three nonresident salesmen operating from Armco sales offices in Pennsylvania, Kentucky and North Carolina. These salesmen visited West Virginia once or twice each month. J.A. 19. Steel salesmen did not handle wire rope products, and wire rope salesmen did not handle steel products. J.A. 21. In addition, the Circuit Court found that "about 77 percent of these West Virginia sales of steel and wire rope products are to three customers whose orders are solicited without this state." J.S. 26a.[2]

Also relevant to this appeal is a brief description of Armco's business activities in West Virginia other than the sales of the three product lines at issue. Those activities were of two types during 1970 through 1975. First, Armco conducted a substantial coal mining, cleaning and sales business in West Virginia. J.A. 11. And second, Armco's Metal Products division maintained an office in West Virginia staffed by two sales engineers and a secretary. J.A. 23. Construction and drainage products manufactured by the Metal Products division were sold by that office, but it was not involved in the sales of steel, wire rope or metal buildings described above. J.A. 24. No dispute is presented here as to the amount of tax owed by Armco to West Virginia with respect to its coal activities or to the activities of its Metal Products division sales office within the state.

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1 Armco's agreements with these dealers provided that the dealers could use Armco's name and trademark, and that Armco would share advertising expenses with them.

2 This finding of fact was apparently based upon testimony with respect to sales figures for the year 1976. J.A. 17.

Proceedings Below

Armco brings this appeal with respect to the application of the West Virginia business and occupation tax to its sales of metal buildings to franchisees located in West Virginia and to its sales of steel and wire rope products shipped to customers located in West Virginia. For each of the years 1970 through 1975 Armco filed West Virginia business and occupation tax returns on which it reported and paid tax upon all coal production within the state and upon all sales by the Metal Products division (of construction and drainage products and metal buildings) to customers located within West Virginia. Armco did not report or pay tax upon its sales of steel or wire rope products shipped to customers in West Virginia.

Upon audit of those returns, the State Tax Commissioner took the position that sales of steel and wire rope products were subject to the tax and issued a Notice of Assessment of Tax against Armco for the period January 1, 1970, through December 31, 1975. Armco petitioned the State Tax Commissioner for reassessment of the Notice of Assessment of Tax, asking (i) that the additional assessment with respect to sales of steel and wire rope products be abated, and (ii) that tax paid with respect to its sales of metal buildings be refunded. An administrative hearing was conducted on May 23, 1977, and the State Tax Commissioner subsequently affirmed the assessment of tax with respect to all of Armco's wholesale sales of steel, wire rope and metal buildings to customers in West Virginia. *See* Appendix C, J.S. 37a.

Armco appealed the State Tax Commissioner's decision to the Circuit Court of Kanawha County. The Circuit Court reversed the State Tax Commissioner's administrative decision, holding that taxation of the sales at issue by West Virginia would violate the Commerce Clause and Due Process Clause of the Constitution because there was not a sufficient nexus between those sales and the State of West Virginia. *See* Appendix B, J.S. 25a.

The State Tax Commissioner in turn appealed the decision of the Circuit Court to the Supreme Court of Appeals of West Virginia, and the latter court reversed, holding that the nexus constitutionally required need not exist between the state and the specific activities subjected to the tax. It found what it deemed a sufficient nexus by viewing Armco as a "unitary business" and referring to its business activities in West Virginia other than activities relating to the sales being taxed. *See* Appendix A, J.S. 1a.

SUMMARY OF ARGUMENT

This appeal presents another chapter in the evolving resolution of the conflict between legitimate needs for state revenues and rights afforded under the Constitution. For two reasons the scales in this proceeding tip decisively in favor of the constitutional rights.

First, the required nexus is not present here. The Court below held that a state tax on gross receipts from concededly interstate transactions may be imposed without regard to the degree of nexus between those transactions and the taxing jurisdiction. That holding is contrary to prior decisions of this Court, *Norton Co. v. Dep't of Revenue of Illinois*, 340 U.S. 534 (1951), and misapplies the quite different nexus standards applicable to the collection of state use taxes, *National Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551 (1977). In so doing, the Court below abandons the constitutional requirement that the tax be "applied to an activity with a substantial nexus with the taxing State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

The rationale adopted by the Supreme Court of Appeals was that Armco operates a "unitary business . . . under one corporate umbrella" and that therefore the Court below was "not required to separate [the interstate sales in question] and treat them separately for purposes of determining whether in isolation they have a sufficient connection to this State to warrant the imposition of a business and occupation tax." J.S.

15a. This confirmed and expanded the view previously expressed by the Court below that it is not "necessary for there to be a nexus between the particular instate activities of the taxpayer and the activity sought to be taxed." *Western Maryland Ry. v. Hardesty*, 282 S.E.2d 240, 244 (1981). Armco's view is that application of the unitary business principle to find the nexus required for a non-apportioned gross receipts tax on interstate sales is wholly inappropriate.

The unitary business theory was born of the practical necessity of defining the total amount of a taxpayer's net income available for apportionment among various taxing jurisdictions. *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207 (1980). It is not designed and has never been applied for the purpose of establishing nexus or apportioning gross income or receipts to one state or another.

The mischief arising from application of the unitary business theory here is apparent when one considers that Armco's Metal Products division office and coal activities did not contribute in any way in generating the sales in question. Accordingly, this is not a case where a maze of local activities was linked in an economic sense to the sales being taxed. *See General Motors Corp. v. Washington*, 377 U.S. 436 (1964); *Standard Pressed Steel Co. v. Washington Dep't of Revenue*, 419 U.S. 560 (1975). What we are faced with, then, is a form of bootstrap taxation: first, the Metal Products division office and the coal operations, which pay their full share of West Virginia business and occupation taxes, are considered to create nexus with Armco as an entity; and second, that nexus with Armco is then cited as justification for collecting further taxes imposed upon the wholly unrelated sales at issue here. Armco submits that the nexus found in this manner by the Court below is fictitious and cannot support the gross receipts taxes at issue.

The second reason for concluding that West Virginia has gone too far here in a constitutional sense is that the exemption from the business and occupation tax on wholesale sales granted to West Virginia manufacturers discriminates against

interstate commerce. By its terms the West Virginia business and occupation tax is applied to sales of products manufactured outside West Virginia and is not applied to sales of products manufactured within the state. A clearer example of discrimination against interstate commerce would be difficult to imagine, and attempts to obscure this conclusion by reference to other taxes imposed on West Virginia manufacturers do not alter or justify this basic discrimination.

Three Justices of this Court concluded that the same statutory plan in Washington, "on its face, discriminated against interstate wholesale sales to Washington purchasers for it exempted the intrastate sales of locally made products while taxing the competing sales of interstate sellers." *General Motors v. Washington*, 377 U.S. at 459 (Goldberg, J., dissenting).[3] And the Supreme Court of Washington had earlier concluded that the Washington tax on interstate sales was invalid under the Commerce Clause. *See Columbia Steel Co. v. State*, 30 Wash. 2d 658, 192 P.2d 976 (1948).

Even if the West Virginia business and occupation tax on manufacturing were viewed as compensating for the exemption of local manufacturers from the tax on wholesale sales, that exemption would nonetheless cause the tax system to be intrinsically discriminatory against interstate commerce. This is because, if the identical system were imposed in another state, the aggregate tax burden borne by commerce between West Virginia and the second state would necessarily be greater than the burden on intrastate commerce in either of those states.

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3 Justices Stewart and White joined in this dissenting opinion. The tax toward which the quoted comment was directed had been amended prior to the years involved in *General Motors* and so was not at issue in that case.

ARGUMENT

Appellant begins in this appeal at the same point from which the Court below commenced:

> The Due Process Clause and the Commerce Clause of the Constitution of the United States contain standards that must be met in order to sustain state taxation of a business which conducts both local and interstate business.

J.S. 5a.

The Due Process Clause of the Fourteenth Amendment imposes two requirements for such state taxation: a "minimal connection" or "nexus" between the interstate activities and the taxing state, and "a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 219-20 (1980); *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 436-37 (1980).

The Commerce Clause requires that the activity to which such taxation applies have a substantial nexus with the state and that the tax be fairly apportioned, not discriminate against interstate commerce, and be fairly related to the services provided by the state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

A violation of any of these constitutional standards warrants invalidation of a state tax, and Appellant submits that the West Virginia tax on wholesale sales breaches two of them. As applied here it reaches transactions that do not have a substantial nexus with West Virginia, and it discriminates against interstate commerce.

I

THE SALES TAXED HEREIN DID NOT HAVE THE REQUIRED NEXUS WITH WEST VIRGINIA.

The first ground upon which the constitutional invalidity of the taxes involved here is asserted is that there was an insufficient nexus between the interstate sales taxed and the State of West Virginia. The territorial limitation on a state's taxing jurisdiction was expressed many years ago by Justice Holmes:

> The only reason for allowing a State to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic system of wide extent, that gives them a value above what they otherwise would possess. The purpose is not to expose the heel of the system to a mortal dart—not, in other words, to open to taxation what is not within the State.

Wallace v. Hines, 253 U.S. 66, 69 (1920). Stated in more modern terms, the Due Process and Commerce Clauses require a nexus between a transaction subjected to tax and the taxing jurisdiction. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977); *General Motors Corp. v. Washington*, 377 U.S. 436 (1964); *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940). The nexus requirement established by these cases represents the primary means by which this Court has consistently denied to the states any right of extraterritorial taxation. *Norfolk & Western Ry. v. Tax Comm'n*, 390 U.S. 317 (1968); *Wallace v. Hines*, 253 U.S. 66 (1920). The guiding principle is that: "Under both the Due Process and the Commerce Clauses of the Constitution, a state may not . . . 'tax value earned outside its borders.' " *Container Corp. of America v. Franchise Tax Bd.*, 103 S. Ct. 2933, 2939 (1983) (quoting *ASARCO Inc. v. Idaho State Tax Comm'r*, 458 U.S. 307, 315 (1982)). This principle is confirmed in *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 442 (1980), where this Court indicated its

unwillingness to condone the taxation of "extraterritorial values", and in *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354, 372 (1982), where the state's claim for tax was denied on the ground that it was "attempting to reach 'extraterritorial values'."

In appraising whether the West Virginia taxes imposed upon Armco's sales here can survive constitutional scrutiny, it is important to bear in mind that these taxes are not merely collected by the out-of-state seller, as in the case of some use taxes, but are borne by the seller. Also important is the fact that these taxes are imposed upon gross receipts rather than on net income. The nexus problems presented by taxes upon gross receipts are particularly acute:

> A tax upon gross receipts affects each transaction in proportion to its magnitude and irrespective of whether it is profitable or otherwise. Conceivably it may be sufficient to make the difference between profit and loss, or to so diminish the profit as to impede or discourage the conduct of the commerce. A tax upon the net profits has not the same deterrent effect, since it does not arise at all unless a gain is shown over and above expenses and losses, and the tax cannot be heavy unless the profits are large.

United States Glue Co. v. Town of Oak Creek, 247 U.S. 321, 329 (1918). *See also General Motors Corp. v. Washington*, 377 U.S. at 440; *Standard Pressed Steel Co. v. Washington Dep't of Revenue*, 419 U.S. 560, 563 (1975).

The discussion which follows concludes (i) that the nexus between the Armco sales subjected to West Virginia tax and the State of West Virginia was insufficient to permit taxation under the Constitution, and (ii) that the unitary business concept should not be applied to create the required nexus.

A. TRANSACTIONAL NEXUS RULES PRECLUDE TAXATION OF THE SALES IN QUESTION.

At the heart of the controversy here is *Norton Co. v. Dep't of Revenue of Illinois*, 340 U.S. 534 (1951), which held that for gross receipts taxes the nexus test is whether "particular transactions are dissociated from the local business." 340 U.S. at 537. *Norton* involved a Massachusetts manufacturer selling its products in Illinois. The taxpayer maintained a branch office in Illinois with an inventory of frequently purchased items, and Illinois sought to impose its gross receipts tax on all of the taxpayer's sales to Illinois customers. This Court sustained the tax on sales made by the Illinois office and on sales in which the Illinois office acted as intermediary, either receiving orders to be forwarded to Massachusetts or receiving goods in bulk from Massachusetts for reconsignment to separate customers. The *Norton* opinion stated:

> [T]he judgment attributing to the Chicago branch income from all sales that utilized it either in receiving the orders or distributing the goods was within the realm of permissible judgment. Petitioner has not established that such services as were rendered by the Chicago office were not decisive factors in establishing and holding this market.

340 U.S. at 538. However, this Court refused to allow the gross receipts tax to be imposed on sales pursuant to orders sent directly by Illinois customers to Massachusetts and filled by direct shipment from Massachusetts to the Illinois customers, stating that "the State could not reasonably attribute their proceeds to the local business." 340 U.S. at 539.

Armco's local businesses in West Virginia consisted solely of its coal activities and the selling of construction and drainage products. Nowhere in the record of this proceeding, or in the opinion of the Court below, is there the slightest indication that the sales in question were anything other than "dissociated" from those local business activities in West Virginia. On the contrary, the Circuit Court in West Virginia found that

Armco "has met its burden of showing that no local presence contributes to the interstate business." J.S. 28a.

The Court below did not quarrel with the Circuit Court's conclusion that Armco's sales of steel, wire rope and metal buildings to customers in West Virginia were dissociated in the *Norton* sense from Armco's local business activities in the state. Rather, it relied in large measure upon what it took to be the "weakening" of this Court's *Norton* decision by the later decisions in *General Motors*, 377 U.S. 436, and *Standard Pressed Steel*, 419 U.S. 560. Armco submits that these later decisions, rather than weakening *Norton*, confirmed the basic dissociation rule and refined its application.

At issue in *General Motors* was the applicability of a Washington tax to the gross receipts from the interstate sales by various divisions of the taxpayer of cars and related products to dealers in Washington. This Court expressly recognized the validity of the *Norton* dissociation test by stating that in order to avoid the Washington business and occupation tax on gross receipts the corporation "has the burden of showing that the operations of these divisions in the State are 'dissociated from the local business and interstate in nature.' " 377 U.S. at 441. This Court examined the activities of each division of the taxpayer and sustained the tax on direct out-of-state shipments of cars, parts and accessories to dealers within the state only because those sales were so intertwined with the "maze of local connections" as to be incapable of being "dissociated from the local business." 377 U.S. at 448. Thus, *General Motors* is a direct application of *Norton*. Moreover, less than a year later, in *American Oil Co. v. Neill*, 380 U.S. 451 (1965), this Court confirmed its commitment to the *Norton* dissociation test.

The appropriate test was explained by the opinion in *General Motors* in the following terms:

> Where, as in the instant case, the taxing State is not the domiciliary State, we look to the taxpayer's business activities within the State, *i.e.*, the local incidents, to

> determine if the gross receipts from sales therein may be fairly related to those activities.

377 U.S. at 441.

The "dissociation" test under *Norton* and the "fairly related" *General Motors* standard are two sides of the same coin. The tax in *General Motors* was upheld under the *Norton* test because the local business activities of the taxpayer in Washington contributed to and in fact generated the sales being taxed. Dissociation simply did not exist because the sales in question were fairly related to the taxpayer's local business activities. The teaching of *General Motors* relevant to this appeal is apparent from the fact that Armco's local business activities in West Virginia cannot be fairly related to, and in fact had nothing at all to do with, the interstate sales which West Virginia seeks to tax.

The same analysis applies to *Standard Pressed Steel*. There a single product was sold by a Pennsylvania manufacturer to a single customer in Washington, but those sales were found to have been largely generated by the local business of the manufacturer in Washington carried on by a full-time resident employee. This Court reacted to the assertion that the gross receipts from these sales could not be taxed by Washington with some vigor:

> We think the question in the context of the present case verges on the frivolous. For appellant's employee, Martinson, with a full time job within the State, made possible the realization and continuance of valuable contractual relations between appellant and Boeing [the customer].

419 U.S. at 562.

There is no room here for the conclusion that Armco's coal mining activities or its Metal Products division sales office in any way "made possible the realization" of the sales which West Virginia asserts the right to tax. Nor did those activities contribute in any way to the "continuance of valuable contrac-

tual relations" between Armco and its West Virginia customers for steel, wire rope and metal buildings. Accordingly, its sales of those products were dissociated from Armco's local business activities in West Virginia and cannot be taxed by West Virginia under *Norton*.

The conclusion of the Court below that *Norton* is not controlling here because it has been weakened by *General Motors* and *Standard Pressed Steel* is not well taken. Those later cases are examples of situations where, under the *Norton* dissociation test, the interstate sales in question were generated by and so were fairly related to, rather than dissociated from, the taxpayers' local business activities. So viewed, the three decisions in *Norton*, *General Motors* and *Standard Pressed Steel* are entirely consistent and they compel the conclusion that the Armco sales at issue here were dissociated from its local business conducted in West Virginia. Accordingly, the required nexus is absent, and these sales cannot be taxed by West Virginia.

Having rejected *Norton*, the Court below, quoting from its prior decision in *Western Maryland Ry. v. Hardesty*, 282 S.E.2d 240 (1981), found that there was no need for any "nexus between the particular in-state activities of the taxpayer and the activities sought to be taxed." J.S. 14a (quoting 282 S.E.2d at 244). In reaching this conclusion the Court below relied upon the decision of this Court in *National Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551 (1977). *National Geographic*, however, involved the attenuated nexus appropriate where an out-of-state seller is merely being asked to perform the administrative function of collecting a state use tax imposed on another taxpayer. What the Court below failed to take into account was that *National Geographic* cited *Norton* with approval and carefully distinguished situations involving gross receipts taxes:

> However fatal to a direct tax a "showing that particular transactions are dissociated from the local business . . . ," *Norton Co. v. Illinois Rev. Dept.*, *supra*, at 537;

> *American Oil Co. v. Neill, supra*; *Connecticut Gen. Life Ins. Co. v. Johnson*, 303 U.S. 77 (1938), such dissociation does not bar the imposition of the use-tax-collection duty.

430 U.S. at 560 (footnote omitted).

B. THE UNITARY BUSINESS CONCEPT SHOULD NOT BE APPLIED TO CREATE THE REQUIRED NEXUS.

Even though the Court below found *Norton* no longer controlling, it did not reverse the Circuit Court on the ground that it had been wrong in concluding that there was not a sufficient nexus between the transactions subject to tax and the State of West Virginia. Apparently the Court below agreed with that assessment based on traditional nexus standards. Rather, it turned to the unitary business concept to reverse the Circuit Court and support the gross receipts taxes on Armco's sales.

The unitary business principle was described in *Container Corp. of America v. Franchise Tax Bd.*, 103 S. Ct. 2933 (1983), as follows:

> The unitary business/formula apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction. It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction.

103 S. Ct. at 2940.

The unitary business principle is reconcilable with the constitutional prohibition against state taxation of extraterritorial values only by reason of factors peculiar to net income taxes.

The impossibility of allocating a taxpayer's total net income directly among two or more states led to the practice of defining total net income realized by the taxpayer's unitary business and then apportioning that total net income among the states by formulae. No such difficulty is presented by a non-apportioned gross receipts tax such as the West Virginia tax imposed on Armco.

This Court has long recognized that net income was a considerable step removed from the transactions in interstate commerce in which it was earned. *United States Glue Co. v. Town of Oak Creek*, 247 U.S. 321 (1918), approved application of an apportioned net income tax to a corporation's entire net income, including the segment derived from the purchase and sale of goods wholly outside the state. The Court drew the analogy to "ordinary property taxes upon property having a situs within its territory and employed in interstate commerce" which had been previously upheld, 247 U.S. at 327, and described the net income tax as "affecting only the net receipts from exportation after all expenses were paid and losses adjusted and the recipient of the income was free to use it as he chose." 247 U.S. at 328.

Drawing a similar distinction between taxation of net profits and taxation of the interstate activities from which they arose, two years later in *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920), this Court emphasized the indivisibility of net earnings as justifying formula apportionment against the contention that the tax was imposed on income arising from business conducted beyond the boundaries of the state:

> The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. . . . The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which, for all

> that appears in this record, reached, and was meant to reach, only the profits earned within the State.

254 U.S. at 120-21.

The decision in *Underwood* was considered controlling in *Bass, Ratcliff & Gretton Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924), in which a series of transactions in different jurisdictions resulting in net income was equated to Justice Holmes' "organic system of wide extent" to which a state might look "to get the true value of the things within it" and was characterized as a "unitary business." 266 U.S. at 282.

From the outset, therefore, the unitary business principle was the result of this Court's recognition of the facts that (i) net income is a subject of taxation distinct from, albeit in the aggregate attributable to, activities in multiple states, and (ii) separable activities comprising a single "organic system" produce net income which is impossible to allocate to the separate activities or to the jurisdictions in which the activities occurred (other than by formula apportionment). These considerations remain today the sole justification for the unitary business principle. *See ASARCO Inc. v. Idaho State Tax Comm'r*, 458 U.S. 307 (1982); *Container Corp. of America v. Franchise Tax Bd.*, 103 S. Ct. 2933 (1983).

It is critical to note that the impossibility of making a logical division of the net income of a single organic system is absent in the case of gross receipts taxes. Expenses are irrelevant in computation of the tax and, in fact, a gross receipts tax is imposed even if a sale is made at a net loss. Here, while asserting the unitary business principle in order to use Armco's local business activities as justification for taxing Armco's sales of steel, wire rope and metal buildings, West Virginia itself separates receipts from mining activities and wholesaling, subjecting them to gross receipts taxes at different rates.

The unitary business principle does not define which activities are sufficiently connected to a state to be subject to its taxing jurisdiction. It merely defines the outer limits of what a

state may include in the net income base to which formula apportionment may be applied to determine the net income earned within and taxable by the state. Approving rejection of the *Norton* dissociation test by the Court below, and its substitution of a theory of borrowed nexus based upon the unitary business principle, would vastly expand the states' powers of taxation.

Here West Virginia has asserted tax only on receipts from shipments to customers in West Virginia. If the *Norton* transactional nexus is not required, there would appear to be no constitutional barrier to West Virginia asserting tax on all gross receipts of all unitary businesses some aspect of which is carried on in West Virginia, regardless of the destination of shipments from which the receipts arise. While such a result might seem beyond all reason, it would be the quite logical result of the application of the unitary business theory. As Justice McHugh of the West Virginia Supreme Court of Appeals stated in his dissent in *Cincinnati Milacron Co. v. Hardesty*:

> This case is another in the steadily increasing number of cases in West Virginia imposing the business and occupation tax on an out-of-state taxpayer. . . . [T]he result in the case now before this Court illustrates the extreme circumstances on which this Court will seize to impose a business and occupation tax on an out-of-state taxpayer.
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> There has been a steady erosion in the nexus required. An example of the rapacious designs of the state authorities appears in the tax commissioner's brief where the following words are written: "Nexus is automatically met by presence in West Virginia." That doctrine is uncomplicated and simple to apply. I fear that this Court is being lured into that greedy embrace.

290 S.E.2d 902, 904-05 (1982) (McHugh, J., dissenting).

This is not to suggest that the gross receipts taxes sought to be imposed here by West Virginia are rapacious or rise to the

level of a greedy embrace. It is submitted, however, that the application of the unitary business principle to create a sufficient nexus to support those taxes under the Constitution is a misuse of that principle which should not be permitted.

II

THE WEST VIRGINIA TAX ON WHOLESALERS DISCRIMINATES AGAINST INTERSTATE COMMERCE.

From more than a century of Commerce Clause jurisprudence in this Court has emerged the fundamental principle that the Commerce Clause prohibits a state from imposing a tax which discriminates against interstate commerce by providing a direct commercial advantage to local business. *See Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 328-29 (1977); *Halliburton Oil Well Co. v. Reily*, 373 U.S. 64, 72 (1963); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457 (1959); *Nippert v. Richmond*, 327 U.S. 416 (1946); *I.M. Darnell & Son v. Memphis*, 208 U.S. 113, 119-20 (1908); *Walling v. Michigan*, 116 U.S. 446, 455 (1886); *Guy v. Baltimore*, 100 U.S. 434, 443 (1880); *Welton v. Missouri*, 91 U.S. 275 (1876). The concern underlying this prohibition is that permitting the individual states to enact laws favoring local enterprises at the expense of out-of-state businesses would encourage the creation of preferential local trade areas destructive of the free flow of trade envisioned by the Commerce Clause. *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. at 329. *See Dean Milk Co. v. Madison*, 340 U.S. 349, 356 (1951).

The issue addressed here is whether the business and occupation tax under review creates precisely such a preferential trade zone in West Virginia. For the reasons noted below, the tax in fact does function to create such a zone both (i) by its operation independent of other taxing jurisdictions, and (ii) by its operation in a multi-jurisdiction context.

A. THE TAX IS DISCRIMINATORY WHEN VIEWED IN ISOLATION FROM OTHER JURISDICTIONS.

We begin with the terms of the statute. West Virginia imposes its business and occupation tax upon all persons engaging or continuing within the state in selling at wholesale tangible property, but exempts from the tax wholesale sales by manufacturers of products manufactured within the state. The result is that such sales by manufacturers to West Virginia customers are taxed only if the product sold was manufactured outside West Virginia. This exemption causes the West Virginia business and occupation tax, on its face, to discriminate against interstate commerce.

Faced with the clearly discriminatory nature of the West Virginia tax on wholesale sales, the Supreme Court of Appeals noted first that the exemption from the tax on wholesale sales is available to out-of-state corporations which manufacture products in West Virginia. The thought here seems to be that there would be no discrimination against interstate commerce if only the taxpayer would cease engaging in interstate commerce and manufacture its products in West Virginia. This approach not only mistakenly equates the avoidance of interstate commerce with nondiscrimination, it also would tend to induce manufacturers to locate within West Virginia to obtain the tax exemption, thus promoting a preferential local trade zone of a type the Commerce Clause was designed to avoid.

The Supreme Court of Appeals then turned for comfort to the doctrine that a state tax should be assessed in light of its actual effect when considered in conjunction with other provisions of the state's tax statutes. *Maryland v. Louisiana*, 451 U.S. 725, 756 (1981); *Halliburton Oil Well Co. v. Reily*, 373 U.S. at 69; *Gregg Dyeing Co. v. Query*, 286 U.S. 472, 479-80 (1932). The other provision of the West Virginia statute which the Court below concluded should be considered in conjunction with the tax on wholesale sales is the business and occupation tax imposed upon manufacturers in West Virginia. After noting that the tax on manufacturing is imposed at a rate

higher than the rate of tax imposed upon wholesale sales, the Court concluded that an out-of-state manufacturer cannot be heard to complain that it is subject to a tax from which West Virginia manufacturers are exempt, because the out-of-state manufacturer is not subject to the even higher tax on manufacturing which the West Virginia manufacturer pays. That analysis fails to come to grips with the discrimination involved.

While it is no doubt true that West Virginia manufacturers pay a variety of state and local taxes in West Virginia to which out-of-state manufacturers are not subject, the existence of those taxes does not license West Virginia to discriminate against interstate commerce in imposing its tax on wholesale sales in West Virginia. The West Virginia tax on manufacturing cannot justify the local-manufacturer exemption from the tax on wholesale sales because the incident of taxation in one case (manufacturing) is wholly unrelated to that in the other (selling).

The opinion under review suggests that some portion of the higher tax on manufacturing in West Virginia should be considered a substitute for the tax on wholesale sales and that, so viewed, there is no discrimination.

> It requires no great feat of imagination to conclude that the Legislature in placing the business and occupation tax on manufacturing at eighty-eight one hundredths of one percent realized that a manufacturer would also have to dispose of the product either through wholesale or retail sales and that it would be unfair to impose an additional tax on this transaction. Therefore, it created the exemption found in W. Va. Code, 11-13-2.

J.S. 22a-23a. The West Virginia tax on manufacturers, however, is imposed without regard to what disposition is made of their products, with the result that the full tax applies to products which would not be subject to the tax on wholesale sales even if there were no exemption for local manufacturers. For example, no alternative rate, compensating deduction or partial exemption is provided with respect to the manufac-

turer's tax where the taxpayer either (i) uses the product in its own business or (ii) sells the product outside West Virginia.[4] In either event, there is no abatement of the manufacturer's tax.

Moreover, if the speculation of the Court below were correct, an exemption for local manufacturers from the tax on retail sales also would have been provided. No such exemption exists, however. The exemption discussed herein applies only to wholesale sales and a local manufacturer is required to pay the tax on selling for all sales at retail. *See* J.S. 59a-60a. Accordingly, no portion of the manufacturer's tax can be considered to be a substitute for a tax on sales, and products manufactured within the state are thus impermissibly favored in sales transactions within the state.

At one time, the State of Washington employed a gross receipts tax virtually identical except for rates to the one challenged here. The Supreme Court of Washington held that the Washington statute, by exempting local manufacturers from the tax on wholesale sales, violated the Commerce Clause because the exemption placed interstate commerce at a disadvantage in competition with local commerce:

> In our opinion the statute marks a discrimination against interstate commerce in levying a tax upon wholesale activities of those engaged in interstate commerce, which tax is, because of the exemption contained in § 8370-6, not levied upon those who perform the same taxable act, but who manufacture in the state of Washington. The statute is therefore violative of the commerce clause of the Federal constitution, and is invalid.

Columbia Steel Co. v. State, 30 Wash. 2d 658, 664, 192 P.2d 976, 979 (1948).

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4 The tax on sales could not apply in either event because the statute requires both that there be a sale and that it be within the state. Moreover, a clear line of decisions of this Court holds that a state may not impose a non-apportioned gross receipts tax with respect to sales in another state. *See Evco v. Jones*, 409 U.S. 91 (1972), and cases cited therein.

After the decision in *Columbia Steel*, the Washington statute was amended in 1950 to impose the gross receipts tax on wholesale sales by both in-state and out-of-state manufacturers. The Supreme Court of Washington's response to that amendment emphasized that the critical distinctions between the previously rejected scheme and its acceptable successor were the elimination of the exemption for local manufacturers from the tax on sales and the shift from manufacturing to selling as the taxable incident for local manufacturers. This change, the Court stated, placed all manufacturers on equal footing with regard to the taxation of their sales:

> All those who sell at wholesale within this state are now taxed equally upon that activity regardless of whether they manufacture in Washington or elsewhere. . . . Each state must derive its revenues from what goes on within its own borders. And if Washington's statute exempts local manufacturers from paying their tax as manufacturers, providing they also pay it as sellers, that, as appellant admits, can be of no concern to one who manufactures out of the state. Appellant engages in but one local taxable activity—selling—and as to this it is now taxed on a parity with all others who engage in like activity here.

B.F. Goodrich Co. v. State, 38 Wash. 2d 663, 668-69, 231 P.2d 325, 328 (1951).

As noted previously, looking back some 14 years later three Justices of this Court agreed that the original Washington exemption for local manufacturers had violated the Commerce Clause:

> Prior to its amendment in 1950 the exemptive terms of this "multiple activities" provision were designed so that a Washington manufacturer-wholesaler would pay the manufacturing tax and be exempt from the wholesale tax. This provision, on its face, discriminated against interstate wholesale sales to Washington purchasers for it exempted the intrastate sales of locally made products while taxing the competing sales of interstate sellers.

General Motors v. Washington, 377 U.S. 436, 459 (1964) (Goldberg, J., dissenting).

The Court below observed briefly in a footnote that the Supreme Court of Washington had invalidated a "rather similar business and occupation tax provision" in *Columbia Steel*, but mistakenly believed that the subsequently decided *Alaska v. Arctic Maid*, 366 U.S. 199 (1961), controlled. J.S. 21a-22a. In *Arctic Maid*, a claim was made that a four-percent tax imposed by Alaska on the value of fish acquired by freezer ships from Alaskan waters for freezing and canning in interstate commerce was invalid. The taxpayer complained that this tax discriminated in favor of local fish processors who paid a one-percent tax on fish they caught and sold to the fresh-frozen consumer market. This Court held that the Alaskan tax structure did not discriminate because freezer ships did not compete with those who processed fish for the retail market, thus negating any charge of local competitive advantage. Concluding that the freezer ships and local processors were engaged in entirely different businesses, this Court reiterated the absence of any "iron rule of equality" between taxes laid on different types of businesses.

The reliance of the Court below on *Arctic Maid* was misplaced because the local favoritism in the West Virginia tax structure does not benefit only those who are engaged in different businesses than Armco. Rather, the West Virginia system confers an advantage on any local manufacturer who competes directly in the same type of business with Armco. Accordingly, *Arctic Maid* is simply not in point.[5]

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5 Also not in point here are two other cases relied upon by Appellee in the Motion to Dismiss or Affirm filed in this proceeding. *Caskey Baking Co. v. Virginia*, 313 U.S. 117 (1941), and *Gregg Dyeing Co. v. Query*, 286 U.S. 472 (1932). In *Caskey Baking* this Court found that the taxpayers involved (peddlers and manufacturers) were, like the taxpayers in *Arctic Maid*, engaged in entirely different businesses. 313 U.S. at 120-21. In *Gregg Dyeing*, a system of sales and compensating use taxes was imposed at identical rates on all gasoline sold or stored for consumption within the state; in contradistinction to this appeal, the object of the tax was made clear by the fact that locally refined gasoline shipped to other states was not taxed. 286 U.S. at 475-76.

B. THE TAX IS DISCRIMINATORY WHEN VIEWED IN CONJUNCTION WITH OTHER JURISDICTIONS.

Even if the West Virginia business and occupation tax on manufacturing is deemed to compensate for the exemption of local manufacturers from the tax on wholesale sales, that exemption nevertheless causes the West Virginia tax system to be intrinsically discriminatory against interstate commerce because, when subjected to the identical system in more than one state, interstate commerce between those states will bear a greater tax burden than intrastate commerce.

For example, if Ohio imposed a business and occupation tax identical to that of West Virginia, the activities of manufacturing and wholesaling goods, when both were performed in either one of the two states (*i.e.*, wholly intrastate commerce), would subject the taxpayer to tax on the manufacturing activity, but not on the wholesaling activity. The taxpayer who manufactured identical goods in one of the states and sold them at wholesale in the other, however, would incur liability both for the tax on the manufacturing activity in the first state (in the same amount as the intrastate taxpayer) and for tax on the sales in the second state. As a result, the interstate taxpayer would suffer a total business and occupation tax liability exceeding that imposed on the intrastate taxpayer by an amount equal to the tax on wholesale sales.

In the recent opinion in *Container Corp. of America v. Franchise Tax Bd.*, 103 S. Ct. 2933 (1983), this Court pointed out that "in the interstate commerce context . . . the anti-discrimination principle has not in practice required much in addition to the requirement of fair apportionment." And the opinion also noted that the "first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency—that is ***the formula must be such that, if applied by every jurisdiction***, it would result" in fair apportionment. 103 S. Ct. at 2942, 2943 (emphasis supplied).

The standard of "internal consistency" contemplated by *Container Corp.* is not met here because, if every jurisdiction applied the West Virginia system, interstate commerce would

always be taxed more than intrastate commerce. Since the discrimination against sales in interstate commerce as described above is intrinsic to the West Virginia tax on wholesale sales, that tax cannot be validly imposed on sales by Armco of products manufactured outside West Virginia.

CONCLUSION

For the foregoing reasons, Appellant submits that the application of the West Virginia business and occupation tax to its sales of steel products, wire rope products and metal buildings was unconstitutional. Accordingly, the decision of the West Virginia Supreme Court of Appeals should be reversed.

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Respectfully submitted,

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